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Independence Standards Board - Minutes, Meeting of October 17, 2000: Public Session

Independence Standards Board

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**Independence Standards Board
Minutes
Meeting of October 17, 2000
Public Session**

A public meeting of the Independence Standards Board (ISB, or the Board) was held on October 17, 2000 at the Roosevelt Hotel in Manhattan on Madison and 45th Street.

In attendance were:

Board Members

William T. Allen, Chairman
John C. Bogle
Stephen G. Butler
Robert E. Denham
Manuel H. Johnson
Philip A. Laskawy
Barry C. Melancon (joined at 11:45 AM)
James J. Schiro

Others Present by Invitation

Arthur Siegel - Executive Director, ISB
Bruce Anderson – Earnscliffe Research & Communications (in part)
Thomas W. Dunfee – Ethics Advisor to the Board
Robert K. Elliott – Chairman, AICPA
Alan S. Glazer – Assistant Project Director, Conceptual Framework
Henry R. Jaenicke – Project Director, Conceptual Framework
Susan McGrath – ISB Staff
John Morrissey – Deputy Chief Accountant, SEC
Richard I. Miller – General Counsel
Richard H. Towers – ISB Staff

Deleted: Rick Towers – ISB

The meeting was called to order by Chairman Allen at approximately 10:10 AM. In his opening remarks, he stated that the Board was continuing its work on a conceptual framework for auditor independence, but that its other standard-setting projects had been put on hold pending the outcome of the Securities and Exchange Commission (SEC) rulemaking proposal on auditor independence.

Conceptual Framework

Chairman Allen read, for the record, a letter that both he and Mr. Bogle had received from Lynn Turner, Chief Accountant of the SEC, regarding the Board's conceptual framework project (the letter is attached hereto as Exhibit A).

Chairman Allen then called on Mr. Jaenicke, Project Director for the conceptual framework, to brief the Board on the project's status and on the current issues to be considered by the Board. Mr. Jaenicke reminded the Board members that they had previously received the comment letters on the Discussion Memorandum (DM) and a staff summary of those comments. The summary had also been included in the advance materials for this meeting. Mr. Jaenicke, with the assistance of slides, provided an overview of the structure of the proposed framework and its key elements. He discussed the decisions that had been made in drafting the Exposure Draft (ED) of the conceptual framework, and related them to comments received on the DM.

Mr. Jaenicke stated that the Project Directors and the staff had met twice with the Project Task Force and three times with the Board Oversight Task Force since the February issuance of the DM. He highlighted the issues that had been raised in those meetings, and stated that he would like the Board's direction on two issues in particular.

The first related to the incorporation of perceptions in the definition and goal of independence. Mr. Jaenicke stated that the Project Directors believe that the definition of independence should not refer to perceptions, but that the goal of independence should emphasize the role that perceptions play in supporting user reliance on financial statements. A framework principle would also describe how the Board would incorporate stakeholder perceptions in standard setting. Others believe that both the definition and goal should explicitly refer to perceptions. The arguments for and against including perceptions in the definition had been articulated in two memos sent to the Board in the advance materials for the meeting.

After deliberation, the Board agreed on the following language as the framework's definition:

Auditor independence is freedom from those pressures and other factors that compromise, or can reasonably be expected to compromise, an auditor's ability to make unbiased audit decisions.

The second issue related to the inclusion of "cognitive biases" and personal prejudices in the ED's list of threats to auditor independence. Cognitive biases are errors in the way that people process information and evidence. After discussion and input from Mr. Dunfee, the Board concluded that the other threats on the list incorporated the relevant cognitive biases, and that it was unnecessary to have a separate category for others or for personal prejudices. The Board also concluded that it was unnecessary to include a question asking respondents to the ED whether these biases should be a separate category in the framework.

Mr. Bogle raised an objection to the draft ED's use of the term "stakeholder." After deliberation, the Board decided that the term should be replaced with "investors and other users" wherever possible.

The Board unanimously voted to release the ED for a 90-day comment period after the document has been revised to reflect the Board's tentative conclusions on the matters discussed at the meeting.

Recommendations of the Public Oversight Board's (POB) Panel on Audit Effectiveness

Chairman Allen called on Mr. Towers to brief the Board on the recommendations to the ISB of the POB's Panel on Audit Effectiveness. Mr. Towers stated that the Panel recommended changes to the composition of the Board, but that this subject was on the agenda for the Board's Executive Session.

The first issue that Mr. Towers addressed was the Panel's recommendation to issue guidance on "factors" that audit committees, auditors, and management should consider in identifying and evaluating matters in independence discussions required under ISB No. 1, *Independence Discussions with Audit Committees*. Mr. Towers noted that the AICPA's SEC Practice Section (SECPS) had issued general guidance on implementation in its Practice Alert 99-1. He stated that the staff believes it would be premature for the Board to issue its own guidance, because doing so without the conceptual framework in place could be viewed as "signaling" what the ISB considered questionable. Since the Board has only deliberated on several distinct components of non-audit services, such as appraisals and valuations, it has no institutional view on those issues. The staff therefore recommended that no such guidance be issued at this time.

The second recommendation was that the ISB perform a continuing evaluation of the effectiveness of its standards. Mr. Towers stated that the staff supported this recommendation, but could not gather the information to perform the evaluation itself. Rather, the staff had asked, and the SECPS Peer Review Committee had agreed, to collect the relevant information as part of its reviews. In addition, the staff would continue to monitor SEC Enforcement Division and SECPS Quality Control Inquiry Committee activities to assist in determining the need for clarifying guidance.

Further details on these issues were provided in the materials sent to the Board in advance of the meeting. The Board agreed with the staff's direction and suggestions regarding these Panel recommendations.

Mr. Schiro suggested that the Board endorse the Panel's recommendation to the SEC that it support the ISB in carrying out its mission. After further discussion, the Board decided that this issue would be considered after the SEC's rulemaking was issued, and the future of the Board's activities were clarified.

Earncliffe Research into Perceptions of Auditor Independence and Objectivity

Chairman Allen called on Mr. Anderson of Earncliffe Research & Communications to brief the Board on its research into perceptions of auditor independence and objectivity. His report had been previously distributed to Board members and posted to the ISB's website.

Mr. Anderson explained that the most recent study was the second phase of the initial research commissioned by the Board, and included 51 one-on-one interviews with CEOs, CFOs, audit committee chairmen, buy side investment analysts, and audit firm partners all involved in small to mid cap or technology sector companies. In addition, eight focus group sessions were held in four cities with "responsible investors" – those who took an active part in managing their own portfolios, whose trading habits revealed a longer term orientation, and who studied significant information about the companies they chose to own. Mr. Anderson stated that the results of this second study generally were consistent with those of the first.

Mr. Anderson reviewed the results of his study in some detail, with the assistance of slides, and presented the following key findings:

- Most interviewees felt very confident with the general standard of financial reporting and believe that auditors perform a necessary function in a way that reflects integrity, competence, and independence. Many worried, however, that the perception of the auditor's independence is under increasing pressure, caused by broader participation and heightened media coverage of market events.
- Most felt that pressure to meet earnings expectations is huge and growing, but that earnings management is not new, is often overstated, is largely manageable, and rarely has anything to do with the role of auditors.
- Perceptions of independence were seen as critical, but there was little consensus on how best to safeguard perceptions, whose perceptions should matter, and what cost should be accepted in achieving this objective.
- Most interviewees felt that the ideal standards and safeguards should reflect a combination of anticipation and avoidance, mitigation and management of issues that arise, and tough penalties, with an emphasis on the latter two categories since "anticipation and avoidance" can become too burdensome and ultimately counterproductive.
- Most individual investors had confidence in the financial reporting system with its checks and balances, such as the audit. Few had detailed knowledge of audit procedures, or the safeguards in place to protect auditor independence. The provision of non-audit services unsettled and discomfited some investors.

Avoidance of this practice seemed to be preferred, but disclosure was seen as a helpful alternative step as well.

Possible Future Projects

Mr. Siegel described two potential projects that the staff could initiate. The first is an exploration and clarification of the distinction between audit firm professionals “assisting” the client in generating financial statement information, and “performing” such work themselves. Generally, he explained, audit firm professionals are permitted to provide some level of assistance to firm audit clients in areas where the firm would be prohibited from performing such services for their clients in their entirety. There is no clear guidance, however, for auditors and their clients on where to draw that line.

The second project would explore firm dependency on an audit client. Mr. Siegel stated that there is existing guidance expressed in an SEC “no-action” letter stating that the SEC staff would question the independence of an audit firm that received more than 15% of its revenues from a single or group of related clients. Some believe that this guidance should be refined and articulated more comprehensively, as a client whose fees fell under this ceiling might still be overly significant to an office, a line of business, or to an individual professional.

In response to a question from Mr. Laskawy regarding the criteria used to select these projects, Mr. Siegel explained that a list of potential future projects had been compiled by the staff some time ago with the assistance of Independence Issues Committee members and the SEC staff. These two were selected as they are fundamental issues, the ISB staff sometimes receives questions from auditors on these subjects, and they were not dealt with in the SEC’s rulemaking proposal.

The Board directed the staff to prepare a prospectus on each of these subjects outlining the scope and timing of a proposed project.

Minutes

The minutes of the Board’s July 11, 2000 meeting were adopted unanimously.

Next Meeting

The Board’s next meeting will be held on December 8, 2000 at 10 AM, in the AICPA’s New York offices.

* * * *

The meeting was adjourned by Chairman Allen at approximately 2 PM.

Respectfully submitted,

Susan McGrath

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